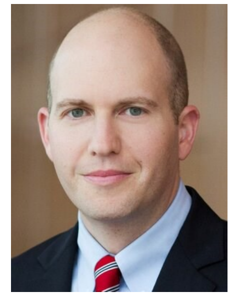
Unpacking Long-Awaited Clean Energy Tax Credit Guidance

By **Casey August, Andreas Andrews and Kathryn Seen** (November 30, 2023)



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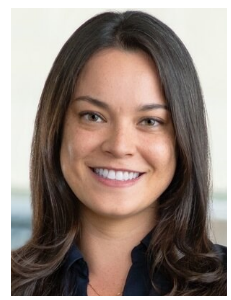

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The U.S. Internal Revenue Service and the U.S. Department of the Treasury released proposed regulations on Nov. 17 addressing the investment tax credit for renewable energy and energy storage facilities, and expanding upon and clarifying prior guidance on applying the ITC following the enactment of the Inflation Reduction Act.

Guidance on the ITC under Section 48 of the Internal Revenue Code had been sought by the renewable energy industry to update the decades-old existing final regulations, long before the enactment of the Inflation Reduction Act.

While the act's changes to the code effectively settled many of the most critical issues on which the industry had sought guidance, the proposed regulations nonetheless provide welcome confirmatory guidance on how to apply the ITC after the Inflation Reduction Act's enactment.

The offshore wind power industry in particular should be pleased by the proposed regulations' approach to the scope of offshore and onshore power conditioning and the transfer equipment eligible for the ITC.

The proposed regulations also provide guidance regarding the application of the ITC recapture rules attributable to a failure to satisfy the Inflation Reduction Act's prevailing wage and apprenticeship, or PWA, requirements.

This guidance is also largely consistent with market expectations, except that the proposed regulations seemingly endorse the position that the apprenticeship portion of the PWA requirements need not be met after the energy project is placed in service.

In addition, the proposed regulations elaborate on previously released Inflation Reduction Act guidance on tax credit transfers under IRC Section 6418, aligning the proposed regulations' approach to PWA requirement-related recapture of the ITC with the transferability guidance's approach to allocating project-level ITC recapture risk to credit transferees.[1]

Taxpayers may generally rely on the rules set forth in the proposed regulations pending the release of final regulations.

Scope of ITC-Eligible Property

General Rules

The proposed regulations addressing general ITC energy property qualification would in large part formalize prior guidance issued by the IRS over the last 30 years, but with certain important updates reflecting new technologies and classes of ITC-eligible equipment resulting from the Inflation Reduction Act.

The proposed regulations reflect the IRS' general technology-neutral, function-oriented approach to determining the types of components that are considered ITC-eligible "energy property" in a manner consistent with the long-standing IRS position, as most clearly reflected in more recent IRS "begun construction" guidance for the ITC.[2]

Under this approach, a unit of energy property would consist of all functionally interdependent components of property that are operated together and that can operate apart from other energy properties within a larger energy project. This would generally include all components necessary to generate or store electricity or thermal energy for transmission, distribution or use up to — but not including — the stage that transmits, distributes, or uses electricity or thermal energy.

The proposed regulations also reflect the long-standing IRS approach in which property considered an integral part of an energy property is itself treated as energy property. Consistent with this prior IRS guidance, the proposed regulations would provide examples of equipment treated as integral, such as power conditioning equipment and transfer equipment — e.g., a step-up transformer — and operations and maintenance roads, as well as examples of equipment not treated as integral, such as fencing, roads primarily used for access to a site or employee parking, and certain buildings.

Importantly, the proposed regulations provide a detailed offshore-wind-facility example that treats all offshore and onshore power conditioning and transfer equipment, up to and including at the onshore substation where the project's electricity is converted to electrical grid voltage, as eligible for the ITC.

The following technology- and Inflation Reduction Act-related changes are reflected in the proposed regulations.

- Solar: The proposed regulations would clarify that the ITC for solar energy includes solar process heat — i.e., solar energy used to produce heat for industrial or commercial processes rather than electricity.

- Energy storage: The proposed regulations would retain the IRC's broad approach to defining new ITC-eligible energy storage property but would include a nonexclusive list of qualifying technologies. ITC-eligible hydrogen energy storage property would be required to store hydrogen used solely for the production of energy and not for the production of end products such as fertilizer.

- Biogas: The proposed regulations would provide examples of eligible components for the new biogas ITC but would exclude upgrading — biogas concentration and purification — equipment as unnecessary to satisfy the statutory emissions standard. This upgrading equipment limitation was not expected by the renewable natural gas industry, and engineering questions remain as to how to distinguish between ITC-eligible cleaning and conditioning equipment, and ITC-ineligible upgrading equipment.

- Microgrid controller: The proposed regulations would clarify that the underlying microgrid electrical system need not be physically connected to a larger electrical grid for ITC eligibility of the microgrid controller.

Co-Located Production Tax Credit and ITC Facilities

The proposed regulations would confirm that a separate IRC Section 45 production tax credit-eligible project may be co-located with a separate ITC-eligible project. Principally, this means that a production tax credit-electing-eligible energy production facility may be paired with an energy storage facility without affecting the ability to claim an ITC for the storage facility.

The Inflation Reduction Act made this approach possible when it enacted a separate ITC for energy storage facilities, as well as production tax credit eligibility for solar energy facilities.

The proposed regulations would allow for an ITC to be claimed on such a facility's power conditioning and transfer equipment (e.g., a step-up transformer) that are properly allocated to the ITC facility — e.g., for which the ITC facility bears the cost — notwithstanding that they are also used by the production tax credit facility.

Limitation on Dual-Use Property Relaxed

Under the existing final ITC regulations, otherwise ITC-eligible energy property may include property that is used by qualifying renewable energy equipment as well as by nonqualifying auxiliary equipment, including renewable energy equipment using another type of source, sometimes called dual-use equipment.

However, the regulations reduce the ITC-eligible basis for dual-use equipment to the extent of its auxiliary equipment use, and completely disallow the ITC for dual-use equipment if the auxiliary equipment use exceeds 25% of its total energy input — the so-called 75% cliff rule. These dual-use equipment rules apply for both initial ITC eligibility and ITC recapture purposes.

Prior to the Inflation Reduction Act's expansion of the ITC to apply to energy storage facilities, these dual-use property limitations effectively precluded a stand-alone energy storage facility from claiming the ITC and in practice also resulted in restrictions or prohibitions on grid-charging an energy storage facility integrated into an ITC-eligible solar or wind generation facility — with the ITC being claimed on the energy storage facility.

Prior to the release of the proposed regulations, practitioners and the market expected that the dual-use property limitations would no longer apply to energy storage facilities integrated with other ITC-eligible projects given the Inflation Reduction Act's enactment of the ITC specific to energy storage facilities.

The proposed regulations confirm this view and would also further relax several dual-use equipment restrictions. Specifically, the proposed regulations would reduce the applicable cliff percentage from 75% to 50% and aggregate all energy inputs from qualifying energy properties as good qualifying source inputs.

Multiple Owners of ITC Property

The proposed regulations also would provide rules on disparate ownership or co-ownership of property across a single ITC-eligible project. While the proposed regulations confirm that each owner may claim an ITC with respect to its owned share of the project, they would generally treat an owner of only integral facility property, such as power conditioning and transfer equipment, and not functionally interdependent components of energy property as ineligible for the ITC.

Thus, for example, a company owning only the subsea cables and voltage transformers of an offshore wind power project that is unrelated to the project owner would be ineligible for the ITC with respect to such equipment.

Qualified Interconnection Property

The Inflation Reduction Act expanded the ITC to apply to certain interconnection costs for smaller-output facilities — not more than 5 megawatts. The proposed regulations would provide certain rules pertaining to this qualified interconnection property, including the following:

- Because qualified interconnection property does not actually constitute energy property, it would not be taken into account when determining whether the associated project's energy property satisfies the domestic content or energy community tax credit adder provisions.

- Any unreimbursed amounts paid or incurred by a taxpayer for property that is constructed, reconstructed or erected by the taxpayer — or for which the cost with respect to the construction, reconstruction, or erection of such property is paid or incurred by such taxpayer — would be included in the tax basis of a related energy property. The Treasury and the IRS are seeking taxpayer comments as to a variety of eligibility and documentation issues pertaining to a taxpayer bearing the unreimbursed cost of qualified interconnection costs.

- The 5-megawatt limitation would be applied on an energy-property-by-energy-property basis. This surprisingly could allow an energy production project with a total nameplate capacity far exceeding 5 megawatts to claim an ITC on qualified interconnection property.

Certain Additional Confirmations

The proposed regulations would confirm that the related-party offtake restriction for production tax credit eligibility does not apply to the ITC.

The proposed regulations also would formalize prior IRS guidance on claiming an ITC on retrofitted property. Under this so-called 80/20 rule, a unit of energy property that incorporates some used property — e.g., a repowered power project — is considered newly placed in service for tax purposes if the fair market value of the used property is not more than 20% of the energy property unit's total value, the cost of the new property plus the value of the used property.

Provisions Related to the Inflation Reduction Act

Prevailing Wage and Apprenticeship

The Inflation Reduction Act significantly revised the terms of the ITC, including by requiring most larger-output projects — at least 1 megawatt — to satisfy PWA requirements with respect to the construction, alteration or repair of the projects in order to obtain the generally expected, before credit adders, ITC of 30% — although this is expressed in the code as a five-times credit amount multiplier from a 6% base amount.

At a high level, the code provides the following PWA requirements:

- All laborers and mechanics performing construction work on the project, and, during the five-year period after the project is placed in service, performing alteration or repair work on the project, must be paid Davis-Bacon Act premised prevailing wages;[3] and

- With respect to the construction of a project, a sufficient number and percentage of laborers — including based on relative laborer hours for the construction, alteration, or repair work for the project — must be performed by qualified apprentices.

The code and the previously released proposed regulations under the PWA requirements provide that a taxpayer's noncompliance with the PWA requirements would not result in a reduction of the associated ITC — e.g., from 30% to 6% — if the taxpayer cures the noncompliance, including by making applicable corrective laborer and IRS penalty payments.

The code provides for the recapture of the ITC with respect to a failure to satisfy the prevailing wage portion of the PWA requirements during the five-year period after the energy project is placed in service — a PWA recapture.

Practitioners and industry participants had not reached a consensus on whether the apprenticeship portion of the PWA requirements also applies with respect to alteration or repair of an energy project after it is placed in service, and had sought clarification from the IRS and the Treasury.

The proposed regulations withdraw certain portions of the previous PWA proposed regulations, repropose the substance of the withdrawn rules with minor changes and propose additional rules with respect to the increased ITC amount available for taxpayers satisfying the prevailing wage requirement.

As for newly introduced provisions, the new proposed regulations would provide that a taxpayer that is claiming an increased ITC amount for a qualifying energy project that fails to satisfy the prevailing wage portion of the PWA requirements during the five-year period after the project is placed in service is subject to recapture of up to 100% — or a portion thereof — of the increased ITC amount.

The proposed regulations are silent as to the apprenticeship portion of the PWA requirements with respect to ITC recapture, seemingly endorsing that the apprenticeship requirement portion of the PWA requirements need not be satisfied once the energy project is placed in service.

The proposed regulations also would provide that the general 20% ITC recapture amount reduction-per-year step-down schedule under Section 50 of the IRC similarly applies for purposes of prevailing wage noncompliance ITC recapture.

Given that the five-year recapture period is unlikely to align with a taxpayer's taxable year, the proposed regulations would provide that the determination of whether a recapture event has occurred be made at the close of the taxable year that begins or ends within a five-year recapture period.

The proposed regulations would further clarify that the failure to satisfy the prevailing wage requirement during this recapture period is subject to cure via correction and penalty provisions in the code without applying ITC recapture.

The proposed regulations would also provide for annual information-reporting requirements that verify compliance with the PWA requirements following the close of each recapture year, consistent with the forms and instructions provided by the IRS.

The IRS anticipates such an annual compliance reporting obligation to be made following the close of each recapture year, at the time the taxpayer files its income tax or other annual returns with the IRS.

The proposed regulations would assess the tax associated with a recaptured ITC amount in the taxable year in which the recapture event occurred. Taxpayers subject to recapture may still be entitled to the base amount of the ITC assuming all other requirements are satisfied.

The proposed regulations would also align prevailing wage noncompliance recapture with other project-level ITC recapture events with respect to a transfer of the ITC under IRC Section 6418, the Inflation Reduction Act's credit transfer provision. Specifically, the proposed regulations employ the approach set forth in the current Section 6418 proposed regulations by imposing this prevailing wage noncompliance recapture liability on the transferee in an ITC sale.

Single Energy Project

Certain new adjustments to the ITC rate enacted by the Inflation Reduction Act, including the PWA requirement, and the energy community and domestic content credit adders, are determined on an energy-project-by-energy-project basis. For these purposes, the proposed regulations would confirm that the single-project factors employed by long-standing ITC and production tax credit "begun construction" guidance would similarly apply to these new Inflation Reduction Act standards.

However, instead of the general facts and circumstances/no bright-line test, which was in the "begun construction" guidance, the proposed regulations require that multiple energy properties meeting two of the seven applicable factors be treated as a single energy project.

A production tax credit facility that is co-located with an ITC energy property would not be considered part of a single ITC energy project.

Taxpayer Reliance on ITC Proposed Regulations

Taxpayers may generally rely on the proposed regulations with respect to property that is placed in service after Dec. 31, 2022, and during a taxable year beginning after the date the final regulations are published in the Federal Register.

Taxpayers may rely on certain rules in the proposed regulations — including those amending the prior IRC Section 6418 credit transferability guidance — with respect to property that is placed in service after Dec. 31, 2022, and during a taxable year beginning on or before the date final regulations are published in the Federal Register, provided that the taxpayer and all related persons apply such proposed rules in their entirety and consistently.

Taxpayers may rely on the PWA provisions of the proposed regulations with respect to construction of energy property or projects begun on or after Jan. 29, 2023, and on or before the date such regulations are published as final regulations in the Federal Register, provided that, beginning after the date that is 60 days after Aug. 29, 2023, taxpayers follow such guidance in its entirety and consistently.

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[1] See our June 23, 2023, Lawflash on Inflation Reduction Act tax credit transfers under IRC Section 6418: https://www.morganlewis.com/pubs/2023/06/inflation-reduction-act-guidance-proposed-on-direct-payment-for-energy-credits.

[2] See IRS Notice 2018-59, 2018-28 I.R.B. 196.

[3] Subchapter IV of chapter 31 of Title 40 of the United States Code.